

## HedgeFolios Strategy Advisory

# “Defensively Positioned as the Bulls Become Exhausted”

3-29-2021

### Our Current View:

The primary factors driving the markets are much the same as they were from our last Strategy Advisory. The new \$1.9 trillion stimulus package passed by Congress, plus reassurances from the Fed that they will continue to support the economy “as long as it takes,” have continued to fuel speculative buying.

Our research suggests that we are not yet near the *ultimate* top in the speculative frenzy. However, from a technical standpoint, we are beginning to see cracks in the ice, which makes an impending correction very likely.

For this reason, we’ve divided our commentary between our shorter- and longer-term outlook:

**SHORTER-TERM:** Momentum appears to be fading from the market, with the most concerning signals appearing on the charts for tech stocks and small caps, both of which had been incredibly strong performers over the past several months.

The QQQ ETF, which tracks the NASDAQ 100 index, is now in trouble, showing a bearish trend and remaining well off its highs from February (now down over 6.5% from that high):

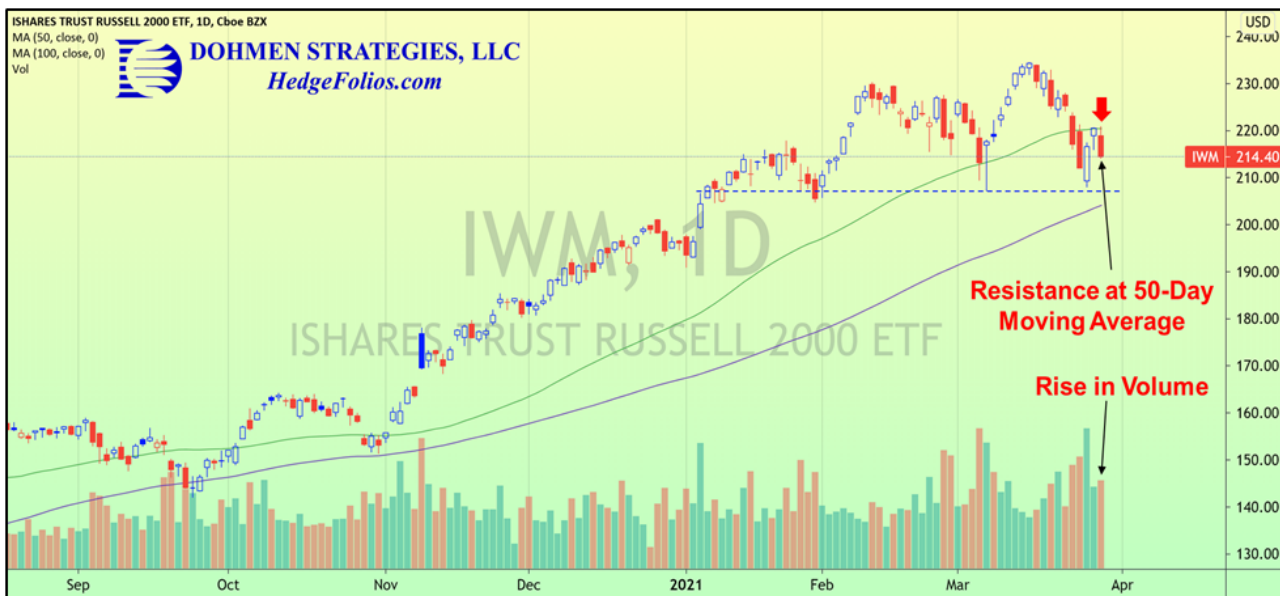


As shown on the chart above, the NASDAQ appeared to stall its decline in early March as dip-buyers

rushed into the market to buy tech stocks, sensing a buying opportunity. It appears they were too eager, as they were met by subsequent rejections at trendline resistance (solid red line).

Small caps, which up until recently had vastly outperformed major large-cap indices like the S&P 500, have seen heightened volatility and tested major support levels. We've noticed a recurring pattern over the past week of trading where the major indices will have small, mixed movements, while the Russell 2000 has made large declines.

This is exactly what we saw once again today (Monday, March 29, 2021), when the Russell tumbled 2.8% while the major indices drifted only slightly lower. We show the chart of the IWM, an ETF tracking the Russell 2000, below. As you can see, the IWM ran into resistance at its 50-day m.a. on Friday (3/26) and again today:



Despite a big drop in trading volume for the overall NYSE and NASDAQ exchanges today, we saw volume pick up for the IWM, signifying conviction among the sellers for this ETF.

This is a great way to trap bullish investors. Several important support levels have already been broken for the NASDAQ, and a similar breakdown for the Russell is likely.

In our view, a bearish catalyst that could spark a prolonged correction is disillusionment from the economic recovery, which will force investors to bring their high-flying expectations back down to realistic levels. The economic recovery is progressing, but several more COVID-19 scares have popped up in Europe and now once again in the U.S.

This appears to already be happening in China. They have claimed to have the pandemic under control for months, yet the CQQQ, a Chinese tech stock ETF, has retraced almost 50% of its progress to its recent all-time high from the lows of last year's crash. Moreover, corporate bond defaults from Chinese companies have surged to an all-time monthly high in March. We show the chart of the CQQQ rise, and recent plunge, below:



If we see a similar mismatch of expectations and reality in the U.S., perhaps if the “reopening” is delayed by a few weeks or more, it could deal a major blow to the markets, which will affect much more than just tech stocks and small caps.

**LONGER-TERM:** What makes us bullish over the longer-term, however, is the incredible stimuli coming from the Fed and the U.S. Treasury. These problems seem to be never-ending. They are already working on a record “infrastructure” bill which will be full of pork for “friends and family” of politicians.

Furthermore, Fed chair Powell vows that the Fed will continue to support the economy with easy money. This reminds us of the Fed policy announced in 1978, which gave us double digit inflation, soaring commodity prices, and rising stocks until 1980 when the Fed finally decided to tighten money, i.e. reduce the availability of credit.

Until the Fed makes a serious change, the continued influx of money into the financial system is likely to continue to flow into the markets rather than the economy, as consumer spending activity remains depressed.

Another potential bullish factor for the longer-term is that the very broad VALUG index, which is not cap-weighted, has finally broken out to a new record high. Below is a long-term weekly chart of the VALUG (candlesticks) versus the S&P 500 (blue line):



The longer-term chart can be deceiving – while the S&P 500 is shown to be higher due to the longer time period displayed, **the VALUG has actually significantly outperformed the S&P 500 since the bottom of the March crash**, rising by an astonishing 122% while the S&P 500 only gained about 80%.

We've shown this chart, however, so you can see the VALUG's ascent to a new high, a milestone which it hasn't achieved since 2018.

This chart shows a preference to the broader market, away from the popular big cap stocks that have propelled the tech sector over the past year, which is another long-term positive.

### Our HedgeFolios:

As active investors, we want to be able to respond quickly when the markets are primed for a correction to avoid losses, which is much more important than holding out for gains.

Thus, given our negative short-term outlook, we've significantly increased our cash allocation in all 5 of our HedgeFolios, primarily by reducing some of our precious metals exposure. With all the crosscurrents currently out there, we believe it is prudent to be cautious at this time.

Once we see further confirmation of an approaching selloff, or correction, we will likely make updates to our models that can take advantage of market declines by utilizing inverse ETFs (i.e. the Opportunistic, Global Equity, and Income models).

If, however, the downturn is brief, we will look for sectors primed to outperform and increase our allocation on the bullish side to take advantage of any further government stimulus, which should help spur the markets higher over the medium-to-longer term.

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**Our Conclusion:**

As we discussed earlier, the major indices appear weak, with a good possibility of an extended correction that could spread from tech stocks and small-caps to the broader market.

Eventually, however, this should be resolved before any plunge gets too severe. There will be ample sector rotation, which at times will seem like the start of new bear markets. The fantastic overvaluations of many stocks will be corrected as sales rise and negative earnings are reduced. That will justify money managers throwing more money into stocks.

We will go with the flow. After a potential correction, we would favor mid-size and large-cap ETFs as their underlying stocks are the ones who would have access to the capital markets.

Wishing you successful investing,

Bert Dohmen and team